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The Coming Rental Housing Wave

Protracted Economic Distress in Housing Sector has Created Legions of Renters in New Markets and New Age Groups

While widespread recovery continues to elude the housing sector, the apartment market has become one of the real estate industry's -- and the broader economy's -- best hopes for a return to the good old days, with robust property values attracting keen investor interest. And it has the Great Recession to thank for it.

The multifamily market is benefitting from changing demographics and consumer attitudes toward renting resulting from the growing number of financially stressed households. The increase in young and newly formed households that have decided to postpone or even reject homeownership in favor of the lower debt and flexibility afforded by renting during these last unsettled economic years.

"It's an exciting time to be in this growing sector where it is projected that \$1 trillion in capital and 10 million additional apartment units are needed in the next 10 years as more individuals turn to apartment living," said Freddie Mac Multifamily Senior Vice President David Brickman.

Renters now make up more than 40 million households - about one-third of total U.S. households, according to Brickman. For every 1% that the current homeownership level of 66% decreases, one million individuals become renters.

The changing demographics also show a significant increase in immigrants, 20-34 year olds, and baby boomers entering the rental market.

"The bottom line is that the multifamily market is poised for growth due to strong demand, healthy fundamentals, and limited supply," Brickman said. "These trends have renewed interest in the sector and investors are returning as evidenced by an increase in acquisition and refinancing activity."

Another 1.4 Million Renters This Year Alone

Through the 12 months ending mid-2011, the Census Bureau reported a net increase of 1.4 million households that moved into rental housing, a 4% rise in the number of tenant households in just one year.

The U.S. homeownership rate has fallen about 1.5% over the past year (from 66.9% to 65.9% during the second quarter of 2011) with owner rates falling by 4.4% (to 21.9%) for those under 25 years of age and by 7% (to 34.7%) for those aged 25 to 29 years.

Apartment rents, which had been flat to falling in many projects during the 2008-2009 recession, have begun to rise, albeit slowly, Freddie Mac reported.

New construction starts of apartments in buildings with at least 20 dwellings have picked up this year and in the second quarter were the highest since the end of 2008.

"New construction starts are slowly picking up and multifamily lending appears to be rising as well with this year's origination volume stronger than 2010's," said Frank Nothaft, Freddie Mac, vice president and chief economist. "In part, the rise in originations is related to the low-level of mortgage rates, improving apartment-sector economics, and the return of traditional lenders that had curtailed activity during the recession."

Apartment Development Ramps Up as Demand Swells

After a surprising delay, the increased demand for rental housing has finally led to a considerable uptick in multifamily construction, the National Multi Housing Council (NMHC) reported in its latest Quarterly Survey of Apartment Market Conditions.

The pace of development activity has increased in most markets. Two-thirds (67%) of respondents noted considerable activity, either in the planning stage or actual new construction.

In particular, 20% said developers are breaking ground on new projects at a rapid clip. The other 47% reported an increase in pre-construction activities-acquiring land, lining up financing, getting building permits-but not much actual construction yet.

Even with this increased activity, more than half (54%) think new development remains considerably below demand.

"Powerful demographic trends, along with changing attitudes about homeownership and tighter mortgage underwriting, continue to drive a shift toward renting, which is fueling a ramp up in new construction," noted NMHC chief economist Mark Obrinsky. "While some survey respondents expressed concern over sporadic overbuilding, others noted that the lack of construction financing may prevent some developments from actually breaking ground."

Rents, Vacancies Benefiting from New Demand

Preliminary third-party data for the third quarter of 2011 suggest that the vacancy rate for institutional investment-type apartment properties has fallen and asking rents have now likely risen for six consecutive quarters, according to Fannie Mae.

Vacancy levels are firmly back to historical norms at an estimated 6.5% for the third quarter of 2011. Asking rents also likely rose again in the third quarter of 2011 by 1% quarter-over-quarter. It appears that full-year 2011 national average asking rent growth remains robust and on track to reach 4%, with effective rents perhaps reaching 5%, or even 6% annualized growth, Fannie Mae said.

While the strength of declining vacancy levels and increasing rental rates will vary by metro area, on a national basis the multifamily sector should continue to see steady improvement for the remainder of the year, Fannie Mae said. It expects average asking rents to experience an annualized increase of 4% and the vacancy rate to stay fairly stable, perhaps declining to 6.25% by the end of the year.

States with Opportunities

CoStar Group senior real estate economist Erica Champion has been tracking the changing housing attitudes during and following the Great Recession.

"For those of us with a special interest in the multifamily sector, we are chomping at the bit to find conclusive answers to questions that have been plaguing us since the collapse in the housing market," Champion said. "Has apartment demand really been that strong? Yes. Are there really that many more people renting apartments? Yes."

With the newest U.S. Census data issued this year, Champion has found some answers.

" 'Robust' is definitely the word for the rise in rental demand that took place over the decade from 2000 to 2010. In line with the drop-off in homeownership that started in 2006, 4.5 out of every 10 households added during the first decade of the new millennium are renters. This is compared to an average rental propensity of 34% in 2000," she said.

The trend has not been evenly apparent from state to state, she said.

"Of the states that added renter households at a faster rate than the national average, some are not a

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surprise. California and Nevada have been poster children of the housing bust and they remain top-ranking states in foreclosure activity, with rates twice the national average. Investors and developers that have been in love with North Carolina and Oregon can congratulate themselves for jumping on the right bandwagon," Champion said.

"The other states are surprises because they are not necessarily the top-of-mind locations for apartment development or investment," Champion added. "Developers and investors may have overlooked some areas with promising demand fundamentals. States such as Ohio, West Virginia, Pennsylvania, and Alabama saw enormous gains in the number of renters - more than six of every 10 households added over the decade were renters. Kentucky, Kansas, Indiana, Missouri, and Oklahoma adding more renters than the national average are also surprises. And there is no evidence to suggest that this boom is driven primarily by the housing bust. The foreclosure rate in West Virginia, Pennsylvania, Alabama, and Kentucky remains one-third the national rate. The rest are on par with or below the U.S. average," she said.

"With one in every two new households renting their homes, these surprise states may present an opportunity worth pursuing to build in a hidden gem location and, in some, to exercise a first-mover advantage," Champion state.

Unmet Demand for Middle Aged

Where Champion sees geographic opportunities, CoStar Group's senior real estate strategist Michael Cohen sees opportunities in an overlooked group.

Few concepts are tossed around more frequently at apartment conferences than the fact that younger households have the greatest propensity to rent, Cohen said.

However, while true, "researchers (and investors) who focus exclusively on the potential impact of the Echo Boomers, are missing a substantial piece of the overall apartment demand story," Cohen said. "The total number of middle-aged households in the U.S. - 35 to 64 years old - outnumbers households under 35 years old by three to one. In turn, 20 million, or half the total number of renter households in the U.S., can be found in this middle-aged demographic."

"Interestingly, as we begin a new wave of apartment construction as evidenced by a steady increase in multifamily starts, I wonder whether developers truly understand the contours of their renter base," Cohen said. "After all, is it the 22-year-old fresh out of college at the leasing office inquiring about stainless-steel appliances and granite countertops? Quite the contrary: more likely than not (well, at least 50% of the time), it's a middle-aged household."

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